MINERALS MANAGEMENT SERVICE

PUBLIC MEETING ON SUPPLEMENTARY PROPOSED RULE

155 Van Gordon Court
Training Room B
Lakewood, Colorado

March 2, 1998

P R O C E E D I N G S

MS. GIBBS TSCHUDY: Welcome to the Minerals Management Service's public meeting on the February 6th Supplementary Proposed Rule Making. Let me introduce the people at the table.

To my far right is Dave Domagala, a Mineral Economist with MMS, and one of the primary authors of the Economic Impact Analysis of the Rule. To his left is Peter Christnacht, also a Mineral Economist with MMS, one of the primary individuals working on the Form 4415 and the instructions.

To my immediate right is Dave Hubbard, he's Chief of our Economic Valuation Branch and one of the primary authors of the Rule. My name is Debbie Gibbs Tschudy, I am Chief of the Royalty Valuation Division.

A few housekeeping items; the rest rooms are down at the end of the hall past the elevators. There's a number of handouts available at the entrance of the door. We do ask that you sign in and sign up if you're interested in speaking. And as long as the court reporter can hear you you can speak from where you sit, but if she has trouble hearing you we'll have to ask you to go to the podium with the microphone.

We had planned on providing a brief explanation of the Supplementary Rule before we opened it up to public comment, but with so few people here could I see a show of hands of those people that are interested in a brief overview? Okay. We'll just go straight to the public comment, then.

The transcripts of this meeting are available from the court recorder. You can get her name and number from her directly and order those transcripts directly from her.

And with that I will open it up to anyone who would like to make a statement. We didn't have anyone sign up to speak, but if there's anyone that would like to come forward and make a comment on the Supplementary Rule you're free to do that at this time. This is not good.

We had a number of questions in the preamble that we specifically wanted public comment on. Could I ask a few of those questions and let me see if anyone's willing to give us some feedback on those questions?

The first was on our definition of the Rocky Mountain area, the six state region; should that definition include other states? Should it exclude some states, particularly New Mexico? We were interested if the whole state of New Mexico should remain in the rest of the country or whether portions of it should be part of the Rocky

Mountains. Is there anyone that cares to comment on that?

Okay. Before I go through all nine questions and their subparts, if I ask any of these questions is there anyone that's going to give me any answers? Can I see a show of hands of anyone who's going to provide any comment on any of the questions? And no one's going to make any statements for the record?

Could you identify yourself, Bill?

MR. STONE: Bill Stone, Exxon. Maybe just a brief overview might spark a few questions. I don't know if the rest of the people want that or not, but if not that's fine.

MS. GIBBS TSCHUDY: Would that make a difference to the attendees, if we did an overview would you make comments?

UNIDENTIFIED SPEAKER: (inaudible)

MS. GIBBS TSCHUDY: I'd be willing to do an overview, but if we aren't going to get any comment on it I don't know if it's worth it or not.

MR. STONE: I guess there may be some points or questions that might need clarification for something that might--the attendees here today.

MS. GIBBS TSCHUDY: Okay. All right. Why don't we just go ahead and go through this. I was just going to give a little bit of background about the Rule and then go through the Rule itself.

The Rule results from changes in the market that have occurred over the last 20 years and our objectives to decrease reliance on posted prices, develop rules that reflect market value and reduce the administrative costs of royalty valuation.

We published the first proposed Rule in January of last year. It said if you had a true outright arm's-length sale value would be based on gross proceeds; however, in the case of a non-arm's-length sale an exchange agreement, a crude oil call or if you bought oil from anyone anywhere in the United States in the last two years value would be based on index, and that was proposed to be the Alaska North Slope spot prices for California and Alaska and NYMEX for the rest of the country, less a location and quality differential.

We published a Supplementary Proposed Rule in July that would eliminate the two-year purchase provision, require payers that had calls on their production to use NYMEX only if the call was exercised and only if it was non-competitive, and it would have allowed payers that had an arm's-length exchange agreement to pay on the resale the arm's-length resale after the exchange.

So under that Supplementary Rule, value would be based on arm's-length gross proceeds with five exceptions.

The first two are contained in the current regulations, in the '88 regulations, and that's that the sales contract does not reflect total consideration; and two, that the value is not reasonable due to misconduct.

The third was if oil was disposed of under an exchange agreement except, again, if you had a simple arm's-length exchange you could base value on the arm's-length resale after the exchange.

The fourth was if an overall balance was maintained between the buyer and the seller, and the fifth was if the lessee had a non-competitive crude oil call that was exercised by the purchaser.

We re-opened the comment period last September and asked for comments on five of the alternatives that came out of the comments on the previous rules. Those five alternatives were to value production sold not arm's-length based on; 1, an outright sale such as a tendering program; 2 would be a new series of benchmarks that were proposed by one trade association; 3 was a proposal by one of the state commenters where MMS would publish values based on prices reported to us for geographic regions; No. 4 was to use fixed or flat differentials as deducts from index prices, and the 5th was a comment from a state commenter that we use spot prices instead of NYMEX.

The comment period closed on that re-opened comment period last November. We held two public meetings during this entire process in April and seven workshops across the country. We've gotten written comments on the five alternatives from 28 different entities, and based on that published this second Supplementary Proposed Rule Making that's the subject of this meeting. It was published February 6th. The comment period closes March 23rd.

In addition to the three public meetings we've already held in Houston, Washington and today in Denver we've got public meetings set next week for Bakersfield on March 11th and Casper on March 12th.

The second Supplementary Proposed Rule is based on five principles, the first being that royalty must be based on the value of production at the lease; the second is that for arm's-length contracts royalty obligations should be based on gross proceeds, and 3, for other than arm's-length contracts MMS still believes that index prices are the best measure of value for most parts of the country.

No. 4, the lessee has a duty to market production at no cost to the federal government, and No. 5, MMS believes that customized regulations for unique producing areas are preferable to a one size fits all approach.

So the second Supplementary Proposed Rule Making proposes that gross proceeds under an arm's-length contract by the lessee or its affiliate determine value with four exceptions. Again, those first two are contained in the '88 regs, they were contained in the January proposal.

The third is oil disposed of under an exchange agreement except one or more exchange agreements, in which case value can be based on the arm's-length resale after those multiple exchanges. The fourth is oil disposed of under a non-competitive crude oil call. Fifth; oil is not sold arm's-length before it's refined, not sold by the lessee or its affiliate. Value is determined differently for three different parts of the country.

In the Rocky Mountain area it's determined based on the first applicable of a series of four benchmarks. The first is an MMS approved tendering program to be approved by MMS. The lessee has to tender at least a third of its federal and non-federal production in an area. It has to receive a minimum of three bids, and value has to be based on the highest of the bid received.

The second benchmark is the weighted average the lessee's or its affiliate's arm's-length sales and purchases in the field or area provided that those arm's-length sales and purchases exceed 50 percent of the lessee's and its affiliate's federal and non-federal production in the field or area.

The fourth is a NYMEX-based price adjusted for a location and quality, and the final is if a lessee can demonstrate that the first three do not yield a reasonable value the value would be determined and established by MMS.

For California and Alaska we've retained a proposal to use the spot price for Alaska North Slope crude adjusted for location and quality, and for the rest of the country the Proposed Rule would rely on spot prices for the market center nearest the lease, again adjusted for location and quality.

And those location and quality adjustments are; 1, from the market center to the aggregation point, the lessee's own actual transportation rates either contained as a location differential in an exchange agreement or an actual transportation contract if they physically move the oil to a market center. If they don't then MMS would publish a rate based on information we collect on a much simplified Form 4415. And from the aggregation point to the lease it would be the actual cost of transportation. We've added a provision to allow the use of quality bank adjustments from the lease to the aggregation point.

And finally, if we have a situation where a lessee is forced to index pricing but they're actually selling at the well head arm's-length so they don't know their transportation costs from the lease MMS will determine the allowance for them.

We've greatly simplified the Form 4415 over earlier proposals. It requires information only on exchanges involving federal oil, only on exchanges between aggregation points and market centers. Much fewer data is required on this form than the earlier form, and there are roughly one-third less MMS identified aggregation points than the previous proposal.

Some of the other proposals that are part of the second Supplementary Rule you may be interested in is that we've changed in response to comments the timing of the index prices so that the production month coincides with the delivery month rather than the trading month as we earlier proposed.

And we've also eliminated any proposed changes to 30 CFR 208, which was the portion of the regs that determine valuing production that we take in kind and make available to eligible refiners. The preamble states instead we decided to establish the value for that oil in the contract we have with the eligible refiner rather than through regulation.

So statistics on how federal crude oil production is distributed across the country; 73 percent of federal crude oil comes from the Gulf, 15 percent from onshore and offshore California, 6 percent from Wyoming, 4 from New Mexico and 2 for the remainder of the Rocky Mountain area.

The Economic Impact Analysis that we completed for the Rule demonstrates how we believe oil will be valued under the second Supplementary Rule. Based on the refining capacity of the various producers by area we estimated how much of the oil would remain on gross proceeds and how much of it would go to index, and as you can see for California and the Gulf over 70 percent will go to index. For New Mexico, the Rocky Mountain areas and Wyoming nearly 70 percent would remain on gross proceeds.

So that's all I had. Are there any public statements now that anybody would like to make or any clarifying questions you might have about the Rule?

MR. STRAIN: I have a question. On the adjustments for the--this is Bill Strain with Chevron; the adjustments, if you don't have a quality bank are you allowing for (inaudible)

MS. GIBBS TSCHUDY: Only to the extent that you are actually incurring quality adjustments and the market has somehow taken into account quality adjustments, so--but if you're not actually either getting a debit or a credit for your quality of your oil then you're not allowed a quality adjustment.

MR. STRAIN: (inaudible)

MS. GIBBS TSCHUDY: Right.

MR. STRAIN: (inaudible)

MS. GIBBS TSCHUDY: To the extent your purchaser made a gravity adjustment in the price you received then that is allowable, but if your purchaser did not and there is not a quality bank then you are not allowed a quality adjustment.

MR. STONE: Bill Stone, Exxon. Would you explain the process when you go directly from the lease to your own refiner?

MS. GIBBS TSCHUDY: In that situation if the oil is not sold arm's-length before it is refined value is determined based on the spot price nearest the lease, and then you are allowed your actual cost of transportation from your refinery--or I should say from the lease to the refinery to determine value at the lease.

There is a provision in the Rule that allows you to demonstrate that applying the spot price at the refinery yields an unreasonable value, and you can demonstrate that by actually showing what the market value of the oil is at the refinery by showing what purchases the refinery makes and at what price, and then again you would be allowed your actual cost of transportation from the lease to the refinery so that we arrive at value at the lease.

MR. STONE: The closest spot price is at the market center?

MS. GIBBS TSCHUDY: At market center. There is a quality adjustment allowed as well, Bill.

MR. HUBBARD: The difference between the quality as produced and the quality of the oil that represents the spot price you'd be allowed a quality adjustment in addition to the transportation from the lease to the refinery.

MR. STRAIN: And the quality adjustment?

MR. HUBBARD: That would have to be on an individual basis, too. You'd have to approach MMS on that. I mean, we wouldn't have a table or anything you could consult.

MS. GIBBS TSCHUDY: Mary?

MS. BLACKWOOD: Mary Blackwood with Amoco. The question has been asked of us as a purchaser if we're purchasing another party's oil in a lease that we own an interest in we fall under the spot index pricing scenario. The way they're--in the regs would they also have to be valued at that even though it is a true arm's-length situation?

MS. GIBBS TSCHUDY: Well, let me clarify. Are you the designee?

MS. BLACKWOOD: Yes.

MS. GIBBS TSCHUDY: Okay. But you're paying on their behalf?

MS. BLACKWOOD: Yes. And it's a true arm's-length, there's no other--

MS. GIBBS TSCHUDY: The value is determined based on the disposition of the lessee's oil, so if a lessee is selling to you arm's-length that determines value. The gross proceeds under that contract determines value.

MS. BLACKWOOD: This producer was understanding the regs that it was--they had to be--

MS. GIBBS TSCHUDY: There's a pretty lengthy explanation in the preamble about if you're the--a working interest owner or a designee or you're an operator who's marketing on their behalf, and there's again, a fairly lengthy discussion I would refer them to in the preamble.

Any other questions or comments?

MR. STONE: Bill Stone, Exxon. In the Rule provision a payor can solicit guidance from MMS that the guidance will be provided that will be non-binding, is there an explanation on why that would be non-binding?

MS. GIBBS TSCHUDY: Essentially the Agency can give you valuation guidance that you can use in determining your royalty payments, but your royalty payments are subject to audit, and the Agency would not be bound by that previous guidance.

MR. STONE: So there is no really at that point the certainty of--

MS. GIBBS TSCHUDY: I would suggest you make written comments on that particular proposal.

Other questions or comments? One question that we asked in the preamble that I think is really important and we would appreciate you focusing on in your written comments, is whether or not the Form 4415 is necessary; that is, that for those lessees that are required to value their production based on index if they are either physically moving the oil to the market center or exchanging it to the market center they would have their own differential information and not need the differential information published by MMS.

We need to know if that's the case if everyone who's going to be paying based on index would have access to their own rates and not need the 4415, and if that's the case could we eliminate the 4415.

Are there any comments on the valuation benchmarks contained in the Rocky Mountain area, specifically the tendering program? Any comments on the one-third requirement?

MS. WILSON: This is Carla Wilson with--I'm sorry--with IPAMS, and I know that my members think it's too high, what percentage it ought to be we have not determined yet and we'll be discussing that on Thursday.

MS. GIBBS TSCHUDY: Yes?

MR. STONE: Bill Stone with Exxon. On that issue there's a clear qualification, I believe, that the other party could not be in a tendering program at that time; over what length of time--at the time you did business with that person if they were not in a tendering program at that time or next year or two years ago or what?

MS. GIBBS TSCHUDY: I believe that you could never tender to someone who had a tendering program in the same area. I don't think we put a time limitation in there.

MR. STONE: So in the past they have had tendering programs and--

MS. GIBBS TSCHUDY: It would be contemporaneous that at the time you're tendering to them they can't be tendering to you is the idea.

MS. WILSON: Can they be tendering to someone else?

MS. GIBBS TSCHUDY: As long as they're not--in order for your tendering program to be approved you've got to receive a minimum of three bids, and those three bids can't come from people who also have tendering programs in existence at the time in the same area. Any comments on that?

All right. Are there any comments about the proposed new or revised definitions in this second Supplementary Rule? For example, we have a revised definition on affiliate.

Are there any comments on the proposal that would allow an arm's-length resale after multiple exchanges? We did get some comments on that at the previous public meetings. I'd appreciate any comments on whether MMS should go back to the January proposal and not allow resale after an exchange.

Any comment on allowing the Cushing spot price for the third benchmark in Wyoming instead of NYMEX? That's another comment we received in Washington, that to be consistent we should just use spot everywhere and using the Cushing spot versus the NYMEX Cushing would result essentially in the same value.

MR. STRAIN: This is Bill Strain with Chevron. I wanted to know if you had any--your logic behind using NYMEX versus spot and along with that how did you arrive at NYMEX versus the spot?

MS. GIBBS TSCHUDY: Because there is not a reliable spot price in the Rocky Mountain area all the commenters told us that the Gurnsey spot price is very thinly traded. There is not an active spot market in the Rocky Mountain area, so the next reliable indicator of market value from an index standpoint was the NYMEX price at Cushing, as well as audits by State of Wyoming auditors under cooperative audit agreements with us show a number of exchange agreements where Wyoming oil is exchanged for oil in Cushing at Cushing.

And then lastly if the lessee can demonstrate that NYMEX isn't reasonable for that area then we've got the fourth benchmark, which is an MMS established method for that area. Any other questions? All right.

Given no responses to any of my questions for public comment I think we'll conclude at this point and I thank you for your time.

(Whereupon, the meeting was concluded at 9:40 a.m.)

REPORTER'S CERTIFICATE

I, Lynn Frost, reporter, hereby certify that the foregoing transcript consisting of 18 pages is a complete, true and accurate transcript of the proceedings indicated, held on March 2, 1998, at 155 Van Gordon Court, Lakewood, Colorado, in the public meeting of the Supplementary Proposed Rule Marking.

I further certify that this proceeding was recorded by me and that the foregoing transcript has been prepared by me.

Date: March 12, 1998

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